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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR. AND ROXANA CATTO

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE FIFTH COURT

BRIEF FOR
JOHN CATTO, JR. AND ROXANA CATTO
IN OPPOSITION

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IN OPPOSITION

JOHN CATTO and ROXANA CATTO pray that the petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in the case of **United States v. John Catto, Jr. and Roxana Catto,** No. 21351, be denied; and respectfully represent:

OPINIONS BELOW

The District Court did not file an opinion. Its findings of facts and conclusions of law in **United States v.**

Catto (R. 38-41)[1], are reported at 223 F. Supp. 663. The **per curiam** opinion of the Court of Appeals (Pet. 18-21) is reported at 344 F.2d 227.

JURISDICTION

The judgment of the Court of Appeals was entered on April 8, 1965 (Pet. 22). The petition for a Writ of Certiorari was filed on September 3, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 1231 of the Internal Revenue Code of 1954, which permits capital gain treatment on property used in the trade or business, provides that livestock, regardless of age held by the taxpayer for draft, breeding, or dairy purposes and held for more than 12 months, are property used in the trade or business which is subject to the allowance for depreciation and is not properly includable in inventory. Treasury Regulation §1.471-6(f) on the other hand provides in part that a taxpayer who uses the "unit-livestock-price method" of valuing inventory must include all livestock raised whether for sale or for draft, breeding or dairy purposes, in inventory. The questions present are:

(1) Whether Treasury Regulation §1.471-6(f), requiring taxpayers to include raised livestock held for draft, breeding or dairy purposes in inventory, is contradictory to the provisions of Section 1231 of the Internal Revenue Code of 1954 and invalid and of no force and effect?

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[1] "R" references are to the printed records in the Court of Appeals.

(2) Whether, the taxpayers, without the consent of the Commissioner of Internal Revenue and in order to correct an error caused by the Commissioner's own regulation, are entitled to remove from inventory raised breeding livestock erroneously included in inventory in compliance with the Treasury Regulation?

STATUTES AND REGULATIONS INVOLVED

The applicable portions of Section 1231 and Section 446 of the Internal Revenue Code of 1954 and Sections 1.446.1 and 1.471.6 of Treasury Regulations on Income Tax (1954 Code), appear in the Appendix, **infra**, pp. 12 - 20.

STATEMENT OF THE CASE

Taxpayers are ranchers who raise cattle for sale. (R. 39). For that purpose they constantly maintain a breeding herd of cattle, to which is added purchased bulls and cows and selected calves raised by their breeding herd. (R. 40).

Since 1938 and during the years in issue the taxpayers kept books and filed income tax returns using the accrual (inventory) method of accounting and used the unit-livestock-price method of valuing inventory. (R. 40-41). In accordance with Treas. Reg. §1.471-6(f) (and its predecessors) taxpayers included raised breeding cattle held for sale in inventory at a unit value and increased the unit values as such cattle advanced in age (R. 41).

The inclusion of these animals in inventory resulted in increasing the taxpayer's ordinary income in the amount of the unit value or the increase in unit value in the year included and increased. If taxpayers were sub-

ject to tax in that year, it resulted in increasing ordinary income tax paid by them. On the other hand, it reduced the amount of income from the sale of cattle that was entitled to capital gain treatment because the taxpayers were required to deduct the accrued inventory value from the sale price in order to compute the amount of profit to which the capital gain rate would apply. (R. 42).

The Commissioner of Internal Revenue has not and does not require ranchers who maintain breeding herds and report their income on the cash receipts and disbursements basis to include raised breeding animals in inventory. (R. 42). Thus, such taxpayers enjoy the advantage of deducting the cost of raising breeding cattle against ordinary income and computing their capital gain on the sale of such cattle on a zero basis.

During the years in question taxpayers did not file a request to change from the accrual (inventory) method of accounting to the cash receipts and disbursements method as during such period the Commissioner refused to consider such requests. (R. 44).

After the Fifth Circuit's decision in **Scofield v. Lewis,** 251 F.2d 128, the taxpayers filed a timely claim for refund for the years in question claiming that Treas. Reg. §1.471-6(f) was contradictory to Section 1231 of the Internal Revenue Code of 1954, and, therefore, invalid and of no force and effect; and that they were entitled to correct the error caused by the Regulation. (R. 43-45). Said claim was neither rejected nor paid and after the expiration of six months taxpayers sued for a refund and the District Court rendered judgment in their favor (R. 44, 50). The Fifth Circuit affirmed **per curiam** on the authority of its earlier decision in **Scofield v. Lewis, supra,**

and held the Treasury Regulation requiring an accrual basis rancher using the unit-livestock-price method to include raised breeding cattle in inventory invalid. (Pet. 20-21).

ARGUMENT

The decisions of the Court of Appeals for the Eighth and Ninth Circuits in **United States v. Ekberg**, 291 F.2d 913 (C.A. 8), certiorari denied, 368 U.S. 920, and **Little v. Commissioner**, 294 F.2d 661 (C.A. 9), with which the petitioner asserts a conflict, are distinguishable from the the Fifth Circuit's decision in the instant case and **Scofield v. Lewis, supra.** Further review of the issue by this Court is unnecessary.

1. The Treasury Regulation Contravenes the Statute and is Invalid

The essential question here is whether the Commissioner of Internal Revenue can by Regulation rise above the statute. The statute plainly and unambiguously states that breeding herd livestock, regardless of age, held for more than 12 months are property used in the trade or business subject to the allowance for depreciation and not properly includable in inventory. Treasury Regulation §1.471-6(f), however, requires a taxpayer who uses the unit-livestock-price method in valuing inventory to apply it to all livestock raised, whether raised for sale in the ordinary course of business or for inclusion in the breeding herd.[2] Thus, the Regulation compels such a taxpayer to include raised breeding livestock in inventory.

[2] This identical regulation was in force for many years prior to the amendment of Section 117(j) of the Internal Revenue Code of 1939 (Revenue Act of 1951, §324, 65 Stat. 452), in 1951, specifically authorizing capital gain treatment for profits on the sale of breeding cattle. See Treas. Reg. 118, §39.22(c)-6(f), and Treas. Reg. 111, §29.22(c)-6.

The net effect of the Regulation in question is to discriminate against the accrual basis rancher who uses the unit-livestock-price method to value his inventory. He is required to include raised breeding livestock in inventory at a unit value, thereby increasing his ordinary income and tax thereon. When he sells such animals he must deduct the accrued unit value from the proceeds of the sale. A rancher who uses the cash receipts and disbursements method, on the other hand, is not required to include such animals in inventory and pay ordinary income tax thereon, and when such animals are sold he receives capital gain treatment on the entire proceeds. Thus, the Regulation discriminates against the accrual basis rancher, contrary to the clear intent of Congress that the statute was a relief provision applicable alike to all taxpayers within its provisions. **Albright** v. **United States,** 173 F.2d 339, 343 (C.A. 8); H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 53-54; and S. Rep. No. 1631, 77th Con., 2d Sess., p. 50.[3]

The discriminatory effect of the Regulation was brought to the attention of the courts in **Scofield v. Lewis, supra.** The Court of Appeals for the Fifth Circuit held

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[3] From the original enactment of Section 117(j) of the Internal Revenue Code of 1939 [Revenue Act of 1942, §151(b), 56 Stat. 798], until its amendment in 1951 (Revenue Act of 1951, §324, 65 Stat. 452) at which time it was made specifically applicable to livestock, the Commissioner attempted to limit and deny the benefits of the section to the livestock industry. See I.T. 3666, 1944 C.B. 270; I.T. 3712, 1945 C.B. 176; Letter of Commissioner, Aug. 4, 1947, as cited in **Albright** v. **United States,** 173 F.2d 339, 343 (C.A. 8); and Minn. 6660, 1951-2 C.B. 60. However, the Courts uniformly struck down the Commissioner's unfounded attempts to withhold from breeding herd owners the capital gain treatment afforded by Section 117(j). **Albright v. United States, supra; United States v. Bennett,** 186 F.2d 407. (C.A. 5); **Mitchell** v. **United States,** 96 F. Supp. 473 (N.D. Col.); **Miller** v. **United States,** 98 F. Supp. 948 (D. Neb.); **Colvert v. United States,** 101 F.Supp. 675 (E.D. Okla); **Emerson** v. **Commissioner,** 12 T.C. 875; and **Fawn Lake Ranch** v. **Commissioner,** 12 T.C. 1139..

that the Regulation was in conflict with the statute. As to a taxpayer like Lewis, who had elected the unit-livestock-price method, and was thereby compelled to include raised breeding livestock in inventory before it was known that gain upon the sale of breeding herd livestock could be treated as capital gain, the Regulation was invalid.

The Court of Appeals for the Eighth and Ninth Circuits then followed with the decisions in **Ekberg** and **Little.** While these Courts reached a different result, the facts were significantly different and clearly distinguishable. In each instance the taxpayer made his election when he knew, or should have known, the advantages and disadvantages of the unit-livestock-price method. Therefore, those taxpayers had a meaningful option with respect to their accounting method. While the Government fails to recognize this distinction in its Petition in this case, this was the principal ground upon which certiorari was opposed by the Government in the **Ekberg** case. (Br. Op. No. 415, Oct. Term, 1961, p. 7).[4]

Likewise, the Fifth Circuit's decision in **Carter v.**

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[4] In opposing certiorari in Ekberg, the Solicitor General said:
"In **Scofield v. Lewis,** the Fifth Circuit also emphazised its belief that the taxpayer there elected to use the unit-livestock-price method, and thereby subject his breeding herd to valuation by the same method, before it was known that the gain upon the sale of a breeding herd could be treated as capital gain rather than ordinary income. It should be noted that the taxpayer in **Lewis** had carried his breeding herd in inventory since 1939. On the other hand, in the instant case, the taxpayer has been engaged in the business of raising Angus cattle only since 1947 (R. 27-38), and the Court of Appeals pointed out (Pet. A 22) that, in 1944, the Internal Revenue Service issued I.T. 3666, 1944 Cum. Bull. 270, recognizing that capital gains treatment was available upon disposition of breeding cattle if all other necessary elements were satisfied. Therefore, the taxpayer here, **unlike the taxpayer in the Lewis case,** did have a meaningful option with respect to his accounting method when he went into business in 1947." (Emphasis Added)

Commissioner, 257 F.2d 595, limiting the applicability of **Lewis** to its facts, is distinguishable. There, a taxpayer using the farm price method to value inventory had an option (which was not available to the taxpayer in **Lewis** and in the instant case) to include purchased breeding livestock in inventory or not as he chose. See Treas. Reg. §1.61-4(b), **infra.**

The Petitioner's attempt to blame Congress for the disparity of treatment between cash and accrual basis taxpayers is clearly unwarranted. (Pet. 13). The legislative history of Section 117(j) reflects that Congress was concerned only with one consideration, namely, to specifically authorize capital gain treatment for livestock. Neither of the Committee Reports reflect that Congress was even aware of the Commissioner's discriminatory Regulation or the effect the amendment would have on cash and accrual basis taxpayers. S. Rep. No. 781, 82d Cong., 1st Sess., p. 42; H. Rep. No. 486, 82d Cong., 1st Sess., p. 32. Similarly, the Petitioner's assertion (Pet. 14) that the Regulation achieved the force of law through statutory re-enactment is untenable in that (a) Petitioner has failed to establish that Congress had general or specific knowledge of the Regulation in question;[5] (b) the Regulation was not in fact a construction or interpretation of the Statute but was an invalid provision in conflict with the statute, and (c) the statute is clear and

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[5] **Mertens,** Law of Federal Income Taxation, Vol. 1, §3.24, pp. 49-52.
The letter from the Secretary of Treasury to the Chairman of the Senate Finance Committee (98 Cong. Rec., Pt. 6, pp. 8307-8308) referred to in the Petition (Pet. 13) can scarcely be regarded as apprising Congress in most thorough and clear terms of the way in which Commissioner was administering the law. There is no mention or reference to the Regulation nor to the fact that the Commissioner was requiring taxpayers who use the unit-livestock-price method to include raised breeding livestock in inventory.

unequivocal and therefore the rule of statutory re-enactment has no application.[6]

When Congress authorized capital gain treatment on livestock the Regulation became invalid because in conflict with the statute. At that time it became incumbent upon the Commissioner to change the Regulation. His refusal to do so is but another of his unyielding efforts to limit and deny capital gain treatment to the livestock industry.

2. Taxpayers are Entitled to Correct the Error Caused by the Invalid Regulation

Having included raised breeding livestock in inventory in compliance with the invalid Regulation taxpayers are entitled to correct the error and remove such livestock from inventory.[7] The correction of the error is not a change in accounting method which necessitates the Commissioner's consent. **Scofield** v. **Lewis,** 251 F.2d at 132, **United States v. Catto,** (Pet. 12). Moreover, even if a change of accounting method was involved, it would have been useless for these taxpayers to have filed a request as the Commissioner arbitrarily refused to consider an application to change.[8] While the Commissioner may have been vested with discretion to refuse an applica-

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[6] **Mertens,** Law of Federal Income Taxation, Vol. 1, §3.24, p. 48.

[7] There is nothing in the record in this case to support the conclusion that correction of the error would give taxpayers an inordinate deduction against ordinary income in the year in which the correction is made. [Pet. 16, citing dicision of Court of Appeals (Pet. App. A, p. 21)] This would depend on the taxpayers' tax bracket at the time of inclusion and time of removal, about which there is nothing in the record.

[8] It was stipulated that during the years 1954-1958, the Commissioner refused to consider rancher's requests to change from the accrual method to the cash receipts and disbursements method. (R. 9). A similar situation existed in prior years, **Scofield** v. **Lewis,** 251 F.2d at 131.

tion, he was required to exercise his discretion and could not arbitrarily determine issues without even considering the merits. **United States v. Shaughnessy,** 347 U.S. 109, 121; **Yellen** v. **United States,** 374 U.S. 109, 121.

3. No Question of Importance to the Federal Tax Law is Presented.

Taxpayers take exception to the Petitioner's assertion (Pet. 17) that the question presented potentially affects large numbers of taxpayers and will have a substantial impact upon the revenue. The decision of the Court of Appeals has very limited application. As the Petitioner forcefully argued in opposing certiorari in the **Ekberg** case, it only applies to taxpayers who elected the unit-livestock-price method prior to the enactment of Section 117(j) of the Internal Revenue Code of 1939. In addition the District Court in the instant case further restricted the application of the **Lewis** case to those taxpayers who timely correct the error in inventory practices resulting from the invalid regulation (R. 48), of whom there can be but a few at this date.

CONCLUSION

The facts and the legal principles involved in **Lewis** and the instant case are identical. The Petitioner successfully opposed certiorari in **Ekberg** on the ground that there was no conflict. This Court recognized the validity of that argument by denying certiorari. Now the petitioner seeks to do a 180 degree turn. Suddenly, a conflict exists. The petitioner cannot have it both ways. Taxpayers urgently assert that this Court was correct in

denying certiorari in **Ekberg.** It follows that it should be denied here.

Respectfully submitted,

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October, 1965.

APPENDIX

Internal Revenue Code of 1954:

Sec. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * *

(e) **Requirement Respecting Change of Accounting Method.** — Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate. (26 U.S. C. 1964 ed., Sec. 446.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) **General Rule.** — If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more

than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

(b) **Definition of Property Used in the Trade or Business.** — For purposes of this section.

(1) **General Rule.** The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not —

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition or similar property, held by a taxpayer described in paragraph (3) of section 1221.

* * *

(3) **Livestock.** — Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * *

(26 U.S.C. 1964 ed., Sec. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§1.61-4 Gross income of farmers.

(a) **Farmers using the cash method of accounting.** A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year -

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources. The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale or purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). * * *

(b) **Farmers using an accrual method of accounting.** A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in subparagraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471.
* * *

* * *

§446.1 General rule for methods of accounting.

* * *

(e) Requirement respecting the adoption or change of accounting method. * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material

item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

* * *

§1.471-6 Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of §1.446.1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of

animals according to either the "farm - price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of §1.446.1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal with a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and

the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-live-stock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragrah (e) of §1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.